

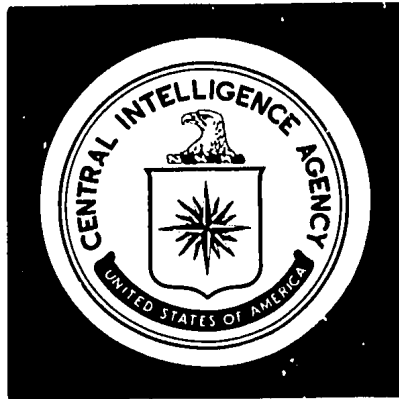
Sanitized Copy Approved for
Release 2011/01/18 :
CIA-RDP85T00875R00170003

Sanitized Copy Approved for
Release 2011/01/18 :
CIA-RDP85T00875R00170003

CIA/OCN [unclear] Doc/ [unclear]

Confidential

25X1



DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Venezuela: Changing Environment for Direct Foreign Investment

CIA
DOCUMENT SERVICES BRANCH
FILE COPY
DO NOT DESTROY

Confidential

ER IM 72-24
February 1972

Copy No. 70

WARNING

This document contains information affecting the national defense of the United States, within the meaning of Title 18, sections 793 and 794, of the US Code, as amended. Its transmission or revelation of its contents to or receipt by an unauthorized person is prohibited by law.

GROUP 1
EXCLUDED FROM AUTOMATIC
DOWNGRADING AND
DECLASSIFICATION

CONFIDENTIAL

25X1

CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1972

INTELLIGENCE MEMORANDUM

**VENEZUELA: CHANGING ENVIRONMENT
FOR DIRECT FOREIGN INVESTMENT**

Summary

1. Following World War II, Venezuela attracted large amounts of direct foreign investment, chiefly from the United States. By the end of 1961 the book value of US direct investment in Venezuela had reached \$3.0 billion, by far the largest in any less developed country (LDC) and 25% of our Third World total. The investment climate became less attractive in the 1960s, however, as Venezuela raised taxes and imposed restrictions on the largely foreign-owned oil industry. Although Caracas continued with considerable success to encourage foreign involvement in most other sectors, oil company disinvestment cut the book value of US direct investment to \$2.7 billion by the end of 1970.

2. Since late 1970, nationalistic actions against foreign firms have accelerated sharply as President Caldera, elected in 1968 with only 30% of the vote, engaged opposition parties in Congress in a tug-of-war for popular support. Tax increases and restrictive legislation aimed mainly at the oil companies have been followed by presidential decrees that have gone even further. Presidential and Congressional measures since November 1970 have preempted development of natural gas exports for the government, greatly toughened regulations governing reversion of company oil concessions scheduled for the early 1980s, and boosted the government's share of gross oil profits from 71% in 1969 to an estimated 90%. The government also has imposed oil export quotas on the companies. These quotas are to be enforced by heavy penalties that under certain circumstances could absorb one-half or more of a company's net earnings after taxes.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

CONFIDENTIAL

25X1

CONFIDENTIAL

3. Foreign firms were shaken by these measures but, after initial outrage, have restrained their complaints for fear of provoking immediate nationalization. The oil companies are disturbed because the higher oil prices required to maintain profit margins in the face of greater tax bites would narrow their markets and because export quotas restrict their ability to adjust Venezuelan output to changes in world oil demand and cost conditions. Under present circumstances, Venezuelan producers are faced with a more severe profit squeeze than are Middle East producers. Nonpetroleum companies are disquieted because they fear similarly harsh restrictions for them may be only a matter of time.

4. Substantial output cutbacks already forced on the two largest oil companies by reduced demand suggest that the industry may fail to meet its first quarter sales quotas, thus possibly triggering the penalty issue in early April 1972. Because further escalation in actions against the companies could lead to their pull-out or immediate nationalization, with heavy losses to Venezuelan budget revenues, export earnings, and economic growth, it is reasonable to expect Caracas to seek some accommodation with the companies. On the other hand, the companies probably would accept substantial reductions in their still-large profits in order to keep operating in Venezuela, hoping that nationalist pressures might relax after the December 1973 elections. In an effort to help ease political pressures on the industry, the companies may seek official Washington action, such as providing Venezuela greater US oil import preferences. Such preferences would also allow the companies to pass on cost increases to US consumers. The environment for nonpetroleum sectors, partly dependent on the outcome in oil, may also be adversely affected by nationalist pressures in the months ahead, but it is not likely to deteriorate sufficiently to cause investment inflows to dry up.

Discussion

Investment Climate and Growth Up to 1971

5. In the first decade or so following World War II, Venezuela offered a fair degree of political stability, generally responsible monetary, fiscal, and foreign payments policies, and a minimum of government restrictions as incentives for foreign investment in its rich petroleum and iron resources. In response to this favorable environment and to rapidly growing world demand, foreign companies (mainly US but also British and Dutch) rapidly expanded their already sizable petroleum investments, and US companies initiated large-scale iron ore exploitation. Moreover, an expanding domestic market during the ensuing boom stimulated foreign investors to enter

CONFIDENTIAL

CONFIDENTIAL

manufacturing, trade, and other sectors. During the 1950s, US direct investment in Venezuela about tripled, and at its peak of \$3.0 billion in 1961 it accounted for one-fourth of total US investment in the LDCs. These large capital inflows helped to boost per capita output rapidly, and by 1959 Venezuela's per capita gross domestic product of \$820 (on a purchasing power parity basis) ranked third in Latin America, being exceeded only by Argentina and Uruguay.

6. From the 1958 overthrow of the Perez Jimenez dictatorship through 1967, however, rising competition from lower-cost oil producers elsewhere and a number of nationalistic moves by the new Venezuelan government made petroleum investment less attractive. Tax measures in late 1958 and again in 1966 raised the government's share of gross oil profits⁽¹⁾ from 52% in 1957 to 68% by 1967. Moreover, President Betancourt's administration, largely for conservationist reasons, adopted the policy of granting no new petroleum concessions. The petroleum companies, being uncertain about their future Venezuelan operations, thus were hesitant to make further large investment expenditures. Following completion of projects in progress, the companies sharply cut their investment spending. Substantial net disinvestment occurred each year during 1962-67 as depreciation allowances exceeded new capital spending, and the book value of US oil holdings dropped from \$2.4 billion to \$1.8 billion in the six-year period. For most other sectors, however, the government's import-substitution policies improved the foreign investment outlook, and the book value of US nonpetroleum investments increased almost 20% compared with 1961. Nevertheless, this rise was not sufficient to offset the drop in oil holdings, and the book value of total US investment shrank to \$2.6 billion at the end of 1967, about 85% of the 1961 peak.

7. During 1968-70, growing concern about Venezuela's declining share in world oil reserves and output brought some change in government attitudes but little lasting improvement in the attractiveness of oil investments. New service contract arrangements were supposed to encourage oilfield exploration and development, but the government moved slowly on applications and no investment of this type actually took place. To protect their existing holdings, however, the companies constructed desulfurization facilities to meet stiffening US anti-pollution requirements, and this spending offset most of the industry's amortization of previous oil investment. Not yet threatened by government restrictions, manufacturing investments continued to increase rapidly and largely accounted for the rise in book value of US direct investment of \$141 million -- or 5.5% -- during these three years.

1. Defined as profits before deduction of Venezuela's royalties and income taxes.

CONFIDENTIAL

CONFIDENTIALPresent Structure of Foreign Holdings

8. US direct investment of \$2.7 billion⁽²⁾ greatly overshadows the holdings of other foreign countries, making up 63% of the estimated book value of total direct foreign investment of \$4.3 billion. US holdings account for about 67% of direct foreign investment in petroleum, virtually all of that in iron mining, and 65% of that in manufacturing. Although US direct investments in Venezuela still are the largest in any LDC, their share of total US investment in the LDCs has declined to only 12.5% - one-half the 1961 level.

9. During the past decade, manufacturing's share of US direct investment in Venezuela increased from 6% to 17% while the share of oil investment dropped from 79% to 64% (see Figure 1). US manufacturing investments, which include a large number and variety of operations, are dominated by holdings in food processing, motor vehicle assembly, and the production of chemicals, pharmaceuticals, and textiles. US investments in trade also are important, with a large number of US-based corporations maintaining sales and distribution facilities in Venezuela. A breakdown by type of activity of the 440 Venezuelan firms in which US companies have full or substantial equity interest is shown in the following tabulation:

<u>Activity</u>	<u>Number of Companies</u>
Agriculture and fishing	12
Mining and metal products	18
Petroleum and oil services	33
Manufacturing	177
Construction and engineering	13
Trade	110
Banking and other finance	45
Other services	32
<i>Total</i>	<i>440</i>

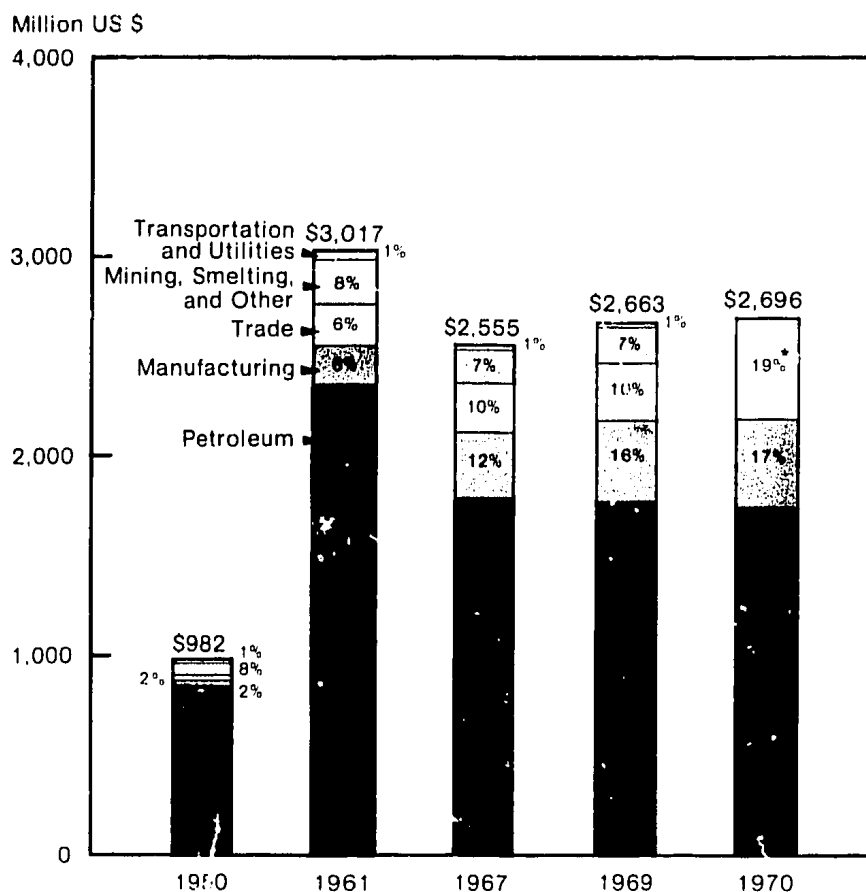
2. Book value at the end of 1970, the latest date for which data are available. In addition to direct investment holdings, US investors held other assets in Venezuela totaling an estimated \$336 million at the beginning of 1970, as follows: long-term commercial bank loans to the central government and its autonomous agencies, \$238 million; Venezuelan company securities, \$88 million; and Venezuelan government bonds, \$10 million.

CONFIDENTIAL

CONFIDENTIAL

Figure 1

**Venezuela: Book Value of US Direct Investment
(Year-End)**



*Breakdown not available for other sectors

513073 2 72

10. British and Dutch direct investments make up most of the remaining foreign holdings. The major part of their investment is in Royal Dutch Shell, Venezuela's second largest petroleum producer. The remaining UK holdings are in manufacturing and banking, while the Netherlands' other investments are mainly in trade and banking. The small holdings of other European countries -- notably France, Italy, Spain, and Sweden -- and Canada are scattered among manufacturing, trade, services, and finance.

CONFIDENTIAL

CONFIDENTIALAcceleration of Nationalistic Moves

11. Since late 1970, foreign firms, mainly in the oil industry, have confronted a sharp acceleration of nationalistic government measures. Caracas has moved decisively to extract greater profit shares, gain greater control over company policies and operations, and exclude foreign investors from certain economic activities. Although such measures have not gone as far in Venezuela as in some other Latin American countries -- Chile very recently and Mexico starting in the 1930s, for example -- they have raised new doubts about the future of oil investments and disturbed the environment for nonpetroleum investments. Recent government actions were precipitated partly by growing budget strains but to a far greater extent by increasing competition for political support between President Rafael Caldera, elected in 1968 with only 30% of the vote, and the opposition parties. Because nationalistic moves against foreign industry enjoy wide popular support, they have escalated in a seemingly endless political tug-of-war. Although an alliance between Caldera's Christian Democrats and the majority Democratic Action (AD) party has given them nominal control of Congress, the alliance has consistently broken down when legislation affecting foreign investors was under consideration.

Measures Affecting Petroleum

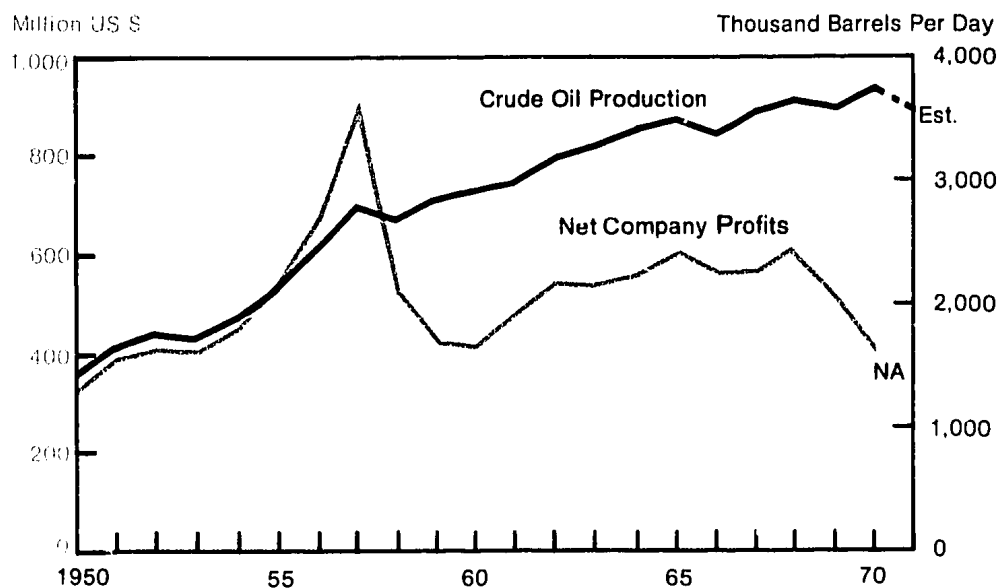
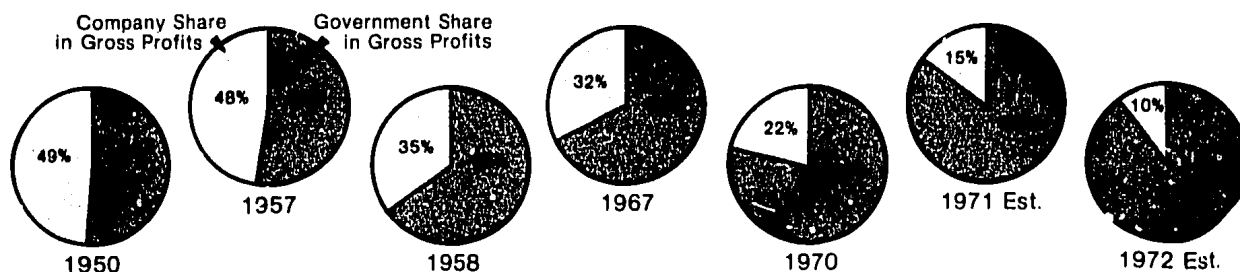
12. Because of their high profile and large net profits of some \$515 million in 1969, the foreign petroleum firms were naturally the prime target of nationalist actions. To help ease budget difficulties, President Caldera in late 1970 submitted a comprehensive tax reform bill to Congress. The AD, sensing an opportunity for major political gains, significantly altered the bill. It greatly increased the proposed maximum corporate income tax rate (affecting mainly the petroleum and iron mining companies), eliminated Caldera's proposals to establish a sales tax and to increase tax rates on domestic business income, and steamrolled the bill through Congress. The law finally signed by Caldera in December raised the maximum tax rate from 52% to 60%, retroactive to 1 January 1970. It also gave the government unilateral power to raise tax reference values (used in valuing oil exports for income tax purposes), which previously had been set through negotiations with the companies. Even with unchanged tax reference values, the new tax rates raised the government's share of gross oil profits from 71% in 1969 to 78% in 1970 (see Figure 2), for which the AD received the public credit.

13. To establish his nationalist credentials, President Caldera in March 1971 used his new authority to boost tax reference values sharply, which raised the government's share of gross oil profits to an estimated 85% for 1971. He also submitted to Congress a law authorizing government

CONFIDENTIAL

CONFIDENTIAL

Figure 2

Venezuela: Crude Oil Production and Industry Profits

513074 2-72

development of liquefied natural gas exports – private initiation of which had been proposed earlier by the companies. The gas in question is a by-product of crude oil output. Only three-fifths of this gas is presently utilized (largely for oilfield injections to maintain well pressure); the remainder is flared. Under Caldera's proposal, much of the gas would have been taken from the companies at low prices, inconveniencing company operations but boosting government revenues and producing political gains for Caldera. To deny him these gains, the AD amended the measure to restrict gas for export to that presently being flared. The amended measure

CONFIDENTIAL

CONFIDENTIAL

also excludes private participation in gas liquefaction but apparently allows participation in the acquisition of gas-carrying tankers.

14. Meanwhile, two minority parties tried to outdo these political moves by pushing through Congress with AD support yet another measure attacking the oil companies. Signed by Caldera in July 1971, this measure empowers the government to regulate drilling and exploration activities, under threat of concession cancellation if companies do not comply. It also substantially toughens requirements concerning concession reversions, many of which are scheduled to occur in the early 1980s. The new measure expands the definition of oil properties subject to reversion to the government to include pipelines, refineries, office buildings, and other company properties not located in the concession areas. Perhaps reflecting experience with previous disinvestment policies of the companies, the law also requires that they deposit 10% of annual depreciation allowances in an escrow fund for repair or replacement of equipment officially judged to be in poor condition when concessions expire. Any amount left over would be refunded. The companies estimate that these payments could amount to as much as \$45 million annually - equivalent to about 11% of net company earnings in 1970. The law's failure to establish standards for determining "poor" condition puts the amount that would be refunded in considerable doubt.

15. To try to regain the political initiative, Caldera issued two decrees in December 1971 that substantially broaden oil industry regulation. The first decree requires the companies to submit for government approval their annual programs for output, exports, and other operations. The second, which goes far beyond legislative requirements, directs the companies to maintain quarterly exports in 1972 near the record 1970 levels. Stiff financial penalties are imposed for reductions of more than 2% below the 1970 base level. For example, if a company's sales fall more than 10% below 1970, the penalties imposed could equal one-half or more of its net earnings. Smaller and apparently more flexible penalties - which partly aim at capturing windfall profits from improved market conditions - are also to be imposed for exports more than 2% in excess of the 1970 levels. Moreover, this decree increased tax reference values for 1972 to a level that could boost the government's gross profit share to an estimated 90%, compared with approximately 80% in Middle East oil-producing countries.

Actions Affecting Other Sectors

16. Congressional moves against foreign firms in nonpetroleum sectors, although predictably less severe, also have been disquieting to foreign investors. Thus far, completed legislation has been limited to the 1970 banking restrictions, but a measure requiring majority Venezuelan

CONFIDENTIAL

CONFIDENTIAL

ownership of pharmaceutical firms may soon come under Congressional consideration. Moreover, a 35-man commission representing the major political parties was appointed by Caldera in February 1971 to prepare legislative recommendations for regulating foreign firms in other nonpetroleum sectors. The banking restrictions - aimed at preventing foreign control and use of domestic savings - prohibited banks with more than 20% foreign participation from accepting savings deposits from Venezuelan residents and from engaging in a number of operations important to commercial banking. Among the seven foreign banks adversely affected by the new law are two US institutions - Chase Manhattan, which cut its previous 49% interest in a Venezuelan bank to 20%, and the First National City Bank, which continues to operate a wholly-owned branch system under the new prohibitions.

Impact of Venezuela's Actions and Initial Company Reactions

17. The oil companies were dismayed by the December 1970 tax increase, which retroactively cut their net profits for the year by one-fifth and their returns per barrel of output by one-fourth. As a result of the tax rise, the government's take increased from 95¢ per barrel in 1969 to \$1.03 in 1970, while company net profits per barrel declined from 39¢ to 30¢. To regain their former profit margins, the companies again raised Venezuelan oil prices in the early months of 1971. The adverse impact of these price increases on the competitiveness of Venezuelan oil initially was muted by price rises for Middle Eastern oil following successful demands for greater profit shares by the other members of the Organization of Petroleum Exporting Countries (OPEC)⁽³⁾ in September 1970 and again in February 1971. A large decline in international tanker rates during 1971 undermined Venezuela's competitive position in the United States and other nearby markets, however, and the country's oil production dropped by 4% for the full year, compared with a 5.3% rise in world output. At the same time, the companies reacted to the new reversion law by initiating proceedings in Venezuelan courts to contest its constitutionality. They were unable, however, to take any action to counteract the gas law.

18. Although 1971 brought the first marked decline in Venezuela's output in more than a decade, its share in the world oil market has been declining for years. By 1970, it supplied only about 14% of world exports

3. In addition to Venezuela, the member countries of OPEC are Abu Dhabi, Algeria, Indonesia, Iraq, Iran, Kuwait, Libya, Nigeria, Qatar, and Saudi Arabia.

25X1

CONFIDENTIAL

CONFIDENTIAL

compared with an impressive one-third a decade earlier.⁽⁴⁾ During this period, Venezuela's oil sales to Europe and South America declined substantially, even in absolute terms, because of its inability to compete with expanding Middle East exports. Its share in the US market also slipped from almost two-thirds to little more than 40%, but its dependence on US purchases increased (see Table 1). Its sales to the United States would have slipped more were it not for US dependence on fuel oil supplies from company refineries on the Venezuelan mainland and in nearby Curacao and Aruba, which developed over the years as US domestic refineries opted to maximize output of higher-valued petroleum products. Venezuelan sales also benefited from the hemispheric preferences given on US imports of No. 2 fuel oil and on crude oil deliveries to refineries in Puerto Rico and the Virgin Islands; these preferences cover about 15% of Venezuela's present oil exports to the US market.

19. Until December 1971, most foreign companies, nevertheless, retained confidence in the future of their Venezuelan operations. The oil companies in particular were counting on a "reasonable" implementation of the reversion legislation, as privately promised by Caldera at mid-year. In fact, during July-September 1971 the Shell, Occidental, and Mobil oil companies signed service contracts to exploit oilfields in southern Lake Maracaibo beginning late in the year at an investment cost of some \$200 million. At the same time, the Creole Petroleum Corp., a Standard Oil of New Jersey affiliate and Venezuela's largest oil producer, announced a planned \$45 million expansion of its recently completed \$120 million desulfurization facilities, and US Steel hesitantly announced plans to go ahead with a \$40 million iron ore enrichment plant.

20. Most foreign companies were shaken by the December decrees because they cast serious doubt on the reasonableness of the Caldera administration, or at least on its ability to withstand irresponsible nationalist pressures in the Congress. The oil companies were particularly disturbed because the export quota system -- which includes the first minimum quotas imposed by any oil-producing country -- threatens their management prerogatives and their ability to adjust production to changing world demand and cost conditions. To retain profit margins in 1972 in the face of the new tax increases, the companies would have to raise crude oil export prices to a level uncompetitive in any part of world market. Because of depressed demand, there is also little chance of forcing fuel oil consumers to absorb the total cost increase -- as they have in the past. Moreover, any penalties for failure to fill export quotas would substantially complicate the problem of passing rising costs on to consumers. Nonpetroleum companies were disquieted by the possibility that similarly harsh restrictions for them might be only a matter of time.

25X1

CONFIDENTIAL

CONFIDENTIAL

Table 1

Venezuela: Exports of Crude Oil
and Refined Products a/

	Percent			
	<u>1960</u>	<u>1969</u>	<u>1970</u>	<u>1971</u> <u>b/</u>
Western Hemisphere	<u>76</u>	<u>80</u>	<u>83</u>	<u>85</u>
United States (including Puerto Rico and Virgin Islands)	48	55	57	58
Canada	10	13	14	13
Central America and Caribbean	8	8	8	10
South America	10	4	4	4
Europe	<u>20</u>	<u>17</u>	<u>15</u>	<u>14</u>
Of which:				
European Community	6	7	6	5
	10	6	5	6
Japan	<u>Negl.</u>	<u>1</u>	<u>1</u>	<u>Negl.</u>
Other areas and countries	<u>4</u>	<u>2</u>	<u>1</u>	<u>1</u>
Total	100	100	100	100

a. The data exclude exports of crude oil to Aruba and Curacao in the Netherlands Antilles and include their exports of refined products. The refineries in Aruba and Curacao are operated by Venezuela's major oil producers and process crude oil almost exclusively for export to the United States. Some Venezuelan crude oil also is shipped to Trinidad and Tobago for refining and exported mainly to the US market. These crude oil shipments are treated as exports to the United States in this table.

b. January-May.

CONFIDENTIAL

CONFIDENTIAL

21. Because of the 11% rise in tax-paid costs, excluding penalties, Venezuelan companies face difficulties in keeping profit margins from declining below their 1970 level of about 30¢ per barrel, much less their higher 1971 level estimated at 35¢. As shown in Table 2, a 16¢ price hike to \$2.48 (f.o.b. Tidewater) would be necessary to maintain company profits in 1972 at 30¢ per barrel. At the currently low world tanker rates, such a hike would make Venezuelan oil significantly more expensive than Middle East oil in the US market, and its existing price disadvantage in other world markets would be considerably worsened. Thus, under present profit-sharing arrangements with their host governments, Venezuelan producers are threatened with a more severe profit squeeze than are Middle East producers. Should penalties be applied for failure to meet export quotas, company profits, of course, would be cut even further.

22. Initial reactions to the severity of Venezuela's new decrees varied. The Creole Petroleum Corp. almost immediately announced its intention to force the issue by ignoring quotas and refusing to pay penalties. Most of the companies - while cutting back investment plans - continued to hope that the government, in the end, would face realities and seek some accommodation with them.

Implications and Outlook

23. Venezuela's recent actions have raised questions concerning the continued competitiveness of Venezuelan oil and the country's position as an important source of US oil imports. Indeed, they have raised questions about the foreign oil companies' ability to continue doing business profitably in the country. Some pessimistic observers fear that the repercussions of these actions and of others resulting from continuing political competition preceding the 1973 elections could push Venezuela far down the extreme nationalist paths of Chile and Peru. Whether or not this will happen depends on the willingness of Caldera's Christian Democrats and opposition parties to sacrifice rational economic considerations to immediate political gains.

24. The first test of how far Caracas is willing to go in pressing nationalist demands against the foreign oil companies could come early this year. Mainly because of abnormally low fuel oil demand on the US eastern seaboard this winter but also because of reduced ability to compete in crude oil markets, the major companies such as Creole and Shell already have cut their production rates considerably below early 1970 levels. Should their exports fall below first quarter quotas, the Venezuelan government in early April will be faced with a decision concerning the severity of the penalties to be applied. Because both Venezuela and the companies still benefit

CONFIDENTIAL

CONFIDENTIAL

Table 2

Relative Competitiveness of Venezuelan and Persian Gulf Oil

US \$ per Barrel of Crude Oil, 25°-27° API Gravity

	Venezuela		Persian Gulf
	1971	1972	1972
Production costs	0.50	0.51	0.12
Income tax and royalties <u>a/</u>	1.47	1.67	1.30
Tax-paid cost	<u>1.97</u>	<u>2.18</u>	<u>1.42</u>
Net company profits	<u>0.35</u> <u>b/</u>	<u>0.30</u> <u>c/</u>	<u>0.30</u> <u>d/</u>
F.O.B. Tidewater	2.32	2.48	1.72
Cost and freight to Philadelphia			
F.O.B. Tidewater	2.32	2.48	1.72
Freight <u>e/</u>	0.21	0.20	0.85
Total	2.53	2.68	2.57
Cost and freight to Trinidad			
F.O.B. Tidewater	2.32	2.48	1.72
Freight <u>e/</u>	0.11	0.10	0.73
Total	2.43	2.58	2.45
Cost and freight to Rio de Janeiro			
F.O.B. Tidewater	2.32	2.48	1.72
Freight <u>e/</u>	0.37	0.34	0.60
Total	2.69	2.82	2.32
Cost and freight to Rotterdam			
F.O.B. Tidewater	2.32	2.48	1.72
Freight	0.44	0.41	0.82
Total	2.76	2.89	2.54

a. Government profit shares for 1972 are based on tax rates and tax prices existing in mid-February.

b. Estimated.

c. Based on an assumed decline to the 1970 level.

d. Computed from quotations for F.O.B. Tidewater less estimated tax-paid cost.

e. Based on Worldscale 75 tanker rates for Venezuela and on Worldscale 65 tanker rates for the Persian Gulf.

CONFIDENTIAL

CONFIDENTIAL

substantially from their existing relationship, pressures to reach a *modus vivendi* will be strong.

Pressures Favoring Accommodation: The Venezuelan Side

25. In deciding on the penalties issue and on other damaging actions against foreign companies, President Caldera will have to consider their impact on new investments required to revive the long-flagging petroleum industry. Maintaining present economic growth rates will depend heavily on tapping new oil reserves because production from presently developed concessions will slip over the next few years as deposits are exhausted and because results of economic diversification efforts so far have been disappointing.⁽⁵⁾ Venezuela almost certainly will have to rely on private foreign firms to supply the large amounts of capital and extensive technological expertise required to develop its untapped reserves of heavy crude oils.

26. Venezuela's dependence on current earnings from the oil industry – some \$1.4 billion in 1970 – is an even more important pressure against Caldera's letting hostilities escalate to the point of triggering company closedowns or making nationalization politically unavoidable. Either development would bring serious losses in government revenues – about 60% of which now comes from the oil companies – and in oil exports, which account for 90% of total export earnings. Venezuela would encounter some difficulties in operating the oil companies' properties, and costs almost certainly would rise. Moreover, it could face virtually insurmountable problems in marketing the oil it did produce if the major international oil companies applied a boycott. Only about 40% of Venezuelan crude is refined domestically, and the major oil companies control the Caribbean refineries that process most of the remainder as well as about 60% of West European refining capacity. Also, these companies and their foreign affiliates market almost all Venezuelan oil now sold in the world market.

27. Venezuela would suffer earnings cuts simply from a loss of international oil company tutelage, even if the companies took no further action of any kind. Although Venezuela's high-cost industry still is competitive with domestic producers in the insulated US market, the major oil companies almost certainly would use lower-priced supplies from other sources to fill their US import quotas if they were no longer directly involved in Venezuelan operations. Because Middle East crude oil now is competitive even with Venezuelan deliveries to nearby Caribbean refineries, Venezuela's corner on the US fuel oil market also depends to a large extent

25X1

CONFIDENTIAL

CONFIDENTIAL

on continued oil company preferences. Independent sales sufficient to retain its already minor market share in other consuming areas such as Western Europe and South America evidently would involve substantial discounting of the prices at which Venezuelan oil now moves. In going it alone, Venezuela, of course, would incur no loss in current per-unit earnings if it cut oil prices by an amount equal to current company profits less the rise in operating and marketing costs deriving from a loss in company tutelage. Under present circumstances, however, a price cut of this size would still leave Venezuelan oil uncompetitive in Western Europe and South America and its position in US and Caribbean markets questionable.

Pressures Favoring Accommodation: The Company Side

28. The oil companies' refusal to pay penalties or yield to other government pressures would expose their large Venezuelan investments to the risk of immediate nationalization. In the case of Standard Oil of New Jersey and Shell Oil Co., the two largest producers, their Venezuelan operations provide a substantial portion of their non-US output - 40% and 30%, respectively. The companies would have to absorb virtually all losses deriving from nationalization. US oil firms' insurance coverage by the Overseas Private Investment Corporation (OPIC) is negligible, mainly because OPIC policy precludes insurance on oil exploration, concession agreements, and investments in sub-surface property rights. On the other hand, yielding to Venezuelan demands for an increasingly large share in industry gross profits does squeeze profits, particularly if compensating price increases are infeasible. For the international oil companies, a "soft line" holds additional risks because of the possible spillover effects on their holdings in other OPEC countries.

29. Because of the nature of US import controls and company marketing decisions, the US market is dependent on Venezuelan oil for an important portion of its imported supplies. Although US imports of Venezuelan crude oil have declined to some 360,000 barrels a day - about one-fourth of total crude oil imports - a shift to other sources could involve some delays and perhaps price increases, depending largely upon available tanker capacity. Moreover, the United States is dependent on Venezuelan supplies for about 80% of total fuel oil imports and more than 70% of the fuel oil consumed on the eastern seaboard. Existing US inventories probably could cover consumer needs during the estimated three months required to reroute Middle East and African oil to Caribbean refineries that now process about one-half of Venezuela's fuel oil exports to the United States. To cover a loss of supplies from Venezuelan domestic refineries over the longer term, new fuel oil refineries would have to be built.

CONFIDENTIAL

CONFIDENTIAL

Possible Resolutions

30. It is reasonable to believe that the Caldera administration recognizes that there are limits beyond which Venezuela cannot profitably go in obtaining a larger share of financial returns from its oil industry. It is even possible that it realizes that wresting management control from the oil companies also would involve considerable financial loss to Venezuela. Thus it would seem likely that Caldera will try to reach some accommodation with the oil companies on such vital issues as penalties -- which provide the teeth for the export quota system. He may be tempted, however, to use the broad escape clause provided in the decree in a discriminatory manner, fining a high-profile company such as Creole, for example, while accommodating the others. Although nationalist pressures are bound to increase in coming months, part of the political appeal of immediate nationalization is offset by the fact that the government already is scheduled to assume ownership of the oil properties in the early 1980s. Considering the enormous potential costs of immediate nationalization, a modicum of reason should compel vying political groups to be content with token moves such as takeover of domestic distribution facilities.

31. For the companies' part, the initial outrage at the unreasonableness of Caracas' recent demands apparently has been largely replaced by a realization of the need to placate at almost any cost. In seeking a more accommodating stance by the Caldera government, they have a strong case and undoubtedly will press it. But in the end, the companies probably will -- if necessary -- accept substantial reductions in their still-large profits in order to keep operating in Venezuela, meanwhile hoping that the post-election climate will be more hospitable. In any event, they can be expected to seek US government cooperation in eliciting a more favorable attitude from Caracas. They certainly would welcome a sympathetic Washington response to Venezuela's recent decision to renounce the outdated reciprocal trade agreement -- last renegotiated in 1952 -- while also hoping to preserve the agreement's oil provisions which form the statutory basis for concessionary tariffs on all US oil imports. They may also seek more far-reaching changes in official relations, such as a long-term energy agreement involving broader preferences for Venezuelan oil which would allow companies to pass on some cost increases to US consumers. Their chief arguments for such an arrangement would be that alternative US oil import supplies come from countries even more politically volatile and that an attractive package offer from Washington could defuse the oil issue in Venezuelan politics.

CONFIDENTIAL

CONFIDENTIAL

32. The investment outlook for nonpetroleum sectors will be strongly colored by developments on the far more prominent oil issue. If the government and the oil companies reach a compromise, the outlook for these investments may well improve somewhat. Even so, the continuing threat posed by political competition for nationalist support in the upcoming election will justify a continued high level of investor caution. The 35-man legislative commission now drawing up new investor rules is considering some restrictions that may approach in severity those contained in the Andean Foreign Investment Code.⁽⁶⁾

6. The Andean Foreign Investment Code applies to Chile, Peru, Colombia, Bolivia, and Ecuador.

CONFIDENTIAL